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BEFORE THE ARIZONA CORPORATION COMMISSION

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ARIZONA CORPORATION COMMISSION
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IN THE MATTER OF THE APPLICATION OF PIMA UTILITY COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.

DOCKET NO. W-02199A-11-0329

IN THE MATTER OF THE APPLICATION OF PIMA UTILITY COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS WASTEWATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.

DOCKET NO. SW-02199A-11-0330

STAFF'S INITIAL CLOSING BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its closing brief in the above-captioned matter. In this brief, Staff will address the major disputed issues. On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

I. INTRODUCTION.

Pima Utilities Inc. ("Pima" or "Company") is a Class B water and wastewater provider in Sun Lakes, Arizona, a community developed by Robson Communities Inc.¹ Pima also provides water and wastewater to two subdivisions adjacent to Sun Lakes. Robson Communities Inc. provides accounting and administrative services to a group of affiliate companies collectively referred to as "Robson".² The Robson family of companies includes the following water and wastewater utilities: Lago Del Oro Water Company; Ridgeview Utility Company; Saddlebrooke Utility Company; Quail Creek Water Company, Inc. Picacho Water Company; Picacho Sewer Company; Mountain Pass Utility Company; Santa Rosa Water Company and Santa Rosa Utility Company.³

¹ Ex. S-5 at Exec. Summ., Brown Dir.

² Ex. A-4 at 2-3, Soriano Dir.

³ Ex. A-4 at 1-2, Soriano Dir.

1 The Company's current rates and charges for water utility service were approved by the
 2 Commission in Decision No. 58743 (August 11, 1994) using a test year ending December 31, 1992.⁴
 3 The Company's current rates and charges for wastewater utility service were approved by the
 4 Commission in Decision No. 62184 (January 5, 2000) using a test year ending December 31, 1997.⁵
 5 The Company filed an application for a rate increase August 29, 2011, for its water and wastewater
 6 divisions. Pima served approximately 20,000 customers, during the test year, which ended December
 7 31, 2010.⁶

8 According to Company witness Steve Soriano, Pima water and wastewater systems have aged
 9 and some facilities have reached the end of their useful lives. Pima has been prudently investing in
 10 the ongoing replacement and rehabilitation of these facilities.⁷ Mr. Soriano also testified that the
 11 impact of these and other capital expenditures on rate base together with the impact of steadily
 12 increasing expenses and regulatory requirements forced Pima to seek a rate increase at this time in
 13 order to earn a fair return on our investment.⁸

14 Below is a summary of the Company and the Staff recommendations for revenue requirement,
 15 based on final schedules:

Water	Revenue Requirement	Revenue Increase	% Increase	Fair Value Rate Base
Company	\$2,717,184	\$739,556	37.40	\$9,122,677
Staff	\$2,434,827	\$457,200	23.12	\$9,122,677

Wastewater	Revenue Requirement	Revenue Increase	% Increase	Fair Value Rate Base
Company	\$3,516,050	\$416,275	13.44	\$9,832,800
Staff	\$3,225,350	\$128,575	4.15	\$9,464,467

26 ⁴ Ex. S-5 at 3, Brown Dir.

27 ⁵ *Id.*

28 ⁶ Ex. A-1 at 2, Jones Dir.

⁷ Ex. A-2 at 5, Soriano Dir.

⁸ Ex. A-4 at 5-6, Soriano Dir.

1 For the water division, Staff's revenue requirement and schedules remain unchanged from its
2 Surrebuttal recommendation. For the wastewater division, the revenue requirement has decreased by
3 \$15,911 from \$3,241,261 in its Surrebuttal to \$3,225,350 in its final recommendation.⁹

4 There are several contested issues remaining. Staff has found excess capacity in the
5 Company's wastewater facility and has recommended an adjustment.¹⁰ The Company and Staff
6 disagree on the salary and wage adjustment proposed by Staff. Although the Company and Staff
7 agree on the amount of rate case expense to be recovered, there is disagreement over the method of
8 recovery. The Company also objects to the Staff recommendation regarding Best Management
9 Practices. No rate case would be complete without a disagreement on cost of capital. And finally,
10 the main focus of this case is the recovery of an allowance for income tax.

11 **II. RATE BASE ISSUES.**

12 The Company is seeking a finding of fair value rate base ("FVRB") in the amount of
13 \$9,122,677 for its water division and \$9,894,162 for its wastewater division, which is the original
14 cost rate base ("OCRB") for both divisions.¹¹ While Staff and the Company are in agreement on the
15 rate base for the water division, they disagree on the rate base for the wastewater division. For the
16 water division, the Company and Staff are in agreement on plant in service in the amount of
17 \$14,571,659.¹² The Company and Staff disagree on the amount of plant in service for the wastewater
18 division; the Company's plant in service total is 22,039,554. Staff has found the plant in service total
19 to be \$21,478,941. Staff removed \$576,077 from the plant in service total for excess capacity found
20 of the Company's wastewater treatment facility.¹³

21 **A. Pima's wastewater reclamation facility contains excess capacity.**

22 Pima currently operates a 2.4 million gallon per day ("MGD") water reclamation facility
23 ("WRF"). Staff witness Marlin Scott testified that based on the flows, the WRF contains excess
24 capacity.¹⁴ Mr. Scott's review of the wastewater flows for the test year showed that the treatment

25 ⁹ Staff Final Sch., CSB-1 (June 26, 2012).

26 ¹⁰ Ex. S-5 at 7, Brown Dir.

27 ¹¹ Company Final Sch., A-1 (Water and Wastewater), Bourassa.

28 ¹² Ex.S-5 at ex. CSB-2, Brown Dir.

¹³ *Id.*

¹⁴ Ex. S-6 at 18, Scott Dir.

1 facility experienced the highest flow of 1,227, 677 gallons per day (“GPD”). For peak day flows, the
2 Company treated 1,438,000 gallons in one day in January of the test year.¹⁵ Using the January peak
3 flow and converting to 143 GPD per service lateral, the WRF could serve up to approximately 16,780
4 service laterals.¹⁶ According to the Company, the build-out customer count estimate is 10,135.

5 Although the Company contends that without the 2.4 MGD treatment facility, it could not
6 have built 3,000 additional homes, the fact remains that the WRF has more than enough capacity at
7 1.6 MGD.¹⁷ When capacity of plant exceeds what is reasonable, ratepayers should not be required to
8 provide a return on such excess. Staff’s adjustment is reasonable and should be adopted.

9 **B. Advances in Aid of Construction (AIAC) and Contributions in Aid of**
10 **Construction (CIAC).**

11 The Company proposed to adopt an adjustment recommended by the Residential Utility
12 Consumer Officer (“RUCO”), for the water division, which would transfer a total of \$423,589 (the
13 test year total AIAC balance plus an additional \$49,353 that was transferred from an accounts
14 payable account) to CIAC.¹⁸ The basis of RUCO’s adjustment was the Company’s response to a
15 Staff data request which proposed transferring the \$374, 236 from AIAC to CIAC and eliminating the
16 accounts payable to a developer, Hancock-MTH Builders, which the Company alleged was
17 bankrupt.¹⁹ Staff maintained that Pima owed the money, therefore, had an obligation to pay. For the
18 wastewater division, the Company adopted RUCO’s adjustment which transferred \$58,099 to CIAC
19 from an accounts payable account and transferred the AIAC balance of \$285,313 to CIAC.²⁰

20 The Company, in its rejoinder testimony, proposed an AIAC balance of \$0 and a gross CIAC
21 balance of \$1,056,007 with an accumulated amortization balance of \$346,223 for the water division
22 and an AIAC balance of \$0 and a gross CIAC balance of \$1,281,739 with an accumulated
23 amortization balance of \$578, 093 for the wastewater division.²¹

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25 ¹⁵ *Id.*

26 ¹⁶ *Id.*

27 ¹⁷ Ex. A-2 at 2-3, Jones Rebt.

28 ¹⁸ Ex. S-10 at 4, Brown Surrebt.

¹⁹ Ex. S-1, DR CSB 1-12.

²⁰ *Id.*

²¹ Ex. A-10 at Sch. B-2 at 2, Bourassa Rejoin.

1 During the hearing, Staff introduced a filing before the Securities and Exchange Commission
2 that suggested that the alleged bankrupt Hancock actually merged into Meritage Homes.²² The
3 Company agreed to contact Meritage to determine if it was the successor and entitled to the payment.
4 The Company, in late-filed exhibit docketed June 20, 2012, confirmed that Meritage was indeed the
5 successor. Pima then made the refunds that were due and owing. The Company issued checks for
6 \$54,410.55 representing the AIAC refund from its water division and \$38,367.15 from its sewer
7 division.

8 Accordingly, after a review of the Company's Late Filed Exhibit, Staff made several
9 adjustments in its final schedules which were docket on June 26, 2012. For the water division, Staff
10 made no changes to the revenue requirement or schedules. For the wastewater division, Staff
11 accepted the changes and reflected the Company's proposed AIAC and CIAC balances. However,
12 Staff's recommended accumulated amortization of CIAC balance of \$24,037 differs from the
13 Company's proposed balance of \$22,995 by \$1,042. Staff's calculation of the accumulated
14 amortization of CIAC is shown on Final Schedule CSB-8. This adjustment results in a change in the
15 revenue requirement for the wastewater division, reducing it by \$15,911 to \$3,225,350.²³

16 **III. OPERATING INCOME ADJUSTMENTS.**

17 **A. Salary and Wages.**

18 The Company sought \$90,294 for salary and wages for officers and directors for each of its
19 divisions.²⁴ Staff's adjustment reduces this expense by \$13,686 for each division.²⁵

20 The Company asserts that the salary level is appropriate because of the responsibilities of the
21 Chairman of Pima, Ed Robson. Company witness Steve Soriano testified that Mr. Robson is
22 ultimately responsible for operations, planning, financing and strategic direction of the Company.²⁶
23 The Company arrived at Mr. Robson's salary by using the salary that was approved in its last rate
24 case and indexed the last approved salary to inflation.²⁷ Earlier in the rate case, the Company

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²² Ex. S-3.

26 ²³ Staff Late-filed Exh. At CSB-9 (June 26, 2012).

27 ²⁴ Ex. S-5 at 14, Brown Dir.

²⁵ *Id.* at 17.

28 ²⁶ Ex. A-5 at 8, Soriano Dir.

²⁷ *Id.* at 9.

1 presented a schedule from its payroll system indicating the number of hours worked by employee.
2 The hours recorded for Mr. Robson were 56.6 hours.²⁸ Mr. Soriano indicated that those hours were
3 in error; Mr. Robson does not keep time sheets.²⁹ Mr. Soriano also testified that while Mr. Robson
4 performs duties for the other utilities in the Robson family of utilities, he is not compensated with a
5 salary from those utilities. The lack of compensation from the other utilities raises issues of whether
6 Mr. Robson's salary is being properly allocated.³⁰

7 As Staff witness Crystal Brown explained, the National Association of Regulatory Utility
8 Commissioners ("NARUC") Uniform System of Accounts discourages the use of estimates.³¹ Ms.
9 Brown further testified that there were no time sheets upon which to audit the reasonableness of the
10 salary requested for Mr. Robson.³² Ms. Brown further testified that the Company's methodology
11 does not follow the NARUC Guidelines for Cost Allocations and Affiliate Transactions. These
12 guidelines incorporate the cost causation principle in allocating costs when those costs cannot be
13 directly charged.³³ Staff maintains that its salary adjustment is reasonable and should be adopted.

14 **B. Rate Case Expense.**

15 The Company and Staff are in agreement on the amount of rate case expense, but disagree on
16 its recovery. Staff has recommended \$400,000 amortized over 5 years.³⁴ The Company has
17 proposed a surcharge for recovery, as was suggested by RUCO in the testimony of its witness, Robert
18 Mease and Timothy Coley.³⁵

19 Company witness Thomas Bourassa testified that a surcharge recovery mechanism would
20 eliminate the concerns surrounding the over or under recovery of rate case expense. Under the
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24 ²⁸ Ex. RUCO-2, DR.

25 ²⁹ Tr. Vol. I at 57:5-20.

26 ³⁰ Ex. S-5 at 15-16, Brown Dir.

27 ³¹ Ex. S-5 at 15, Brown Dir.; Tr. Vol. III at 464:15-17.

28 ³² Ex. S-10 at 5, Brown Surrbt.

³³ Ex. S-10 at 6, Brown Surrbt.

³⁴ Ex. S-5 at 23-24, Brown Dir.

³⁵ Ex. RUCO-3 at 19, Mease Dir.; Ex. RUCO-5 at 26, Coley Dir.

1 Company's proposal, a surcharge of \$0.33 per monthly bill per division would be assessed.³⁶ The
2 surcharge would cease upon complete recovery of the allowed rate case expense.³⁷

3 During the hearing, RUCO witness Mease testified that he was unaware of any jurisdictions
4 that allowed recovery of rate case expense through a surcharge.³⁸ However there are a few
5 jurisdictions that allow a rate case expense surcharge.³⁹ Nebraska appears to have allowed both a
6 surcharge as well as for rate case expense to be amortized over a certain period.⁴⁰

7 The Commission has a long practice of allowing recovery of rate case expense through
8 normalization. *In the Matter of the Application of Sahuarita Water Company LLC*⁴¹, Sahuarita had
9 not been in for a rate case in 14 years. The Commission found that Sahuarita did not have a track
10 record for filing rate applications and that the Staff recommendation of normalizing over five years
11 was appropriate.⁴² While almost every expense incurred by a utility could be potentially surcharged
12 to customers, it is more appropriate to allow Pima to recover through rates. Including costs in rates
13 can encourage utilities to find efficiencies and economies when operating its businesses.

14 **1. Income tax allowance.**

15 Pima is proposing an adjustment that reflects income taxes based on the Company's adjusted
16 test year revenue and expense.⁴³ The Company has proposed to include income taxes in the cost of
17 service even though Pima is a Subchapter S Corporation ("S-Corp") and does not pay income taxes
18 itself.⁴⁴ The Company's test year adjusted results proposed an expense of \$85,405, adjusted with the
19 proposed rate increase of \$139,867 for its wastewater division.⁴⁵ For the water division, Pima's test
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21 ³⁶ Ex. A-8 at 15, Bourassa Rebut.

22 ³⁷ Tr. Vol. I at 18:17-19.

23 ³⁸ Tr. Vol. I at 152:5-9.

24 ³⁹ *In the Matter of Hampstead Area Water Company, Inc.*, 94 N.H. P.U.C. 563 (2009) (New
25 Hampshire); *In the matter of Centerpoint Energy Houston Electric, LLC*, 2005 WL 1668034
26 (Tex.P.U.C.) (Texas); *K N Energy, Inc. v City of Scottsbluff*, 233 Neb. 644, 447 N.W. 227, (1989)
27 (Nebraska).

28 ⁴⁰ *In the Matter of Black Hills/Nebraska Gas Utility Company LLC*, 283PUR4th 384 (2010).
Interestingly, this decision also discusses the recovery of an income tax allowance.

⁴¹ Docket No. W-03718A-09-0359; Decision No. 72177 (February 11, 2011).

⁴² Dec. No. 72177 at 24, W-03718A-09-0359 (Feb. 11, 2011).

⁴³ Ex. A-7 at 13, Bourassa Rebut.

⁴⁴ Ex. A-5 at 15, Soriano Dir.

⁴⁵ Ex. A-6, Sch. C-2 at 13, Bourassa Dir.

1 year adjusted results proposed an income tax allowance of \$27,157: adjusted for proposed rate
2 increase, \$39,984. Staff's adjustments remove those amounts and recommends \$0. Staff maintains
3 that as an S-Corp, the Company is not subject to income tax and the Company's adjustment should be
4 disallowed. Staff's recommendation is in line with recent Commission decisions that support the
5 disallowance of income tax expense for utilities organized as a limited liability company ("LLC")
6 and an S-Corp.⁴⁶

7 Pima is a S-Corp for income tax purposes.⁴⁷ As a consequence of this election, Pima does not
8 pay federal or state income taxes.⁴⁸ The Company witness Spitzer appears to dispute the fact that
9 Pima does not pay federal income tax, by saying "the argument that an S-Corporation does not pay
10 any taxes rests on a technical distinction rather than a reality."⁴⁹ However under questioning from
11 Administrative Law Judge Jibillian, Mr. Spitzer admits that Pima does not pay tax to the Internal
12 Revenue Service or to the state of Arizona.⁵⁰ Income tax is not an expense that is incurred by any
13 pass-through entity.

14 The Company argues that the actual payment in the amount of the expense is not a
15 prerequisite to recovery.⁵¹ The Company appears to argue that all expenses that are allowed for
16 recovery are estimates. The traditional ratemaking methodology starts with test year expenses and
17 then adjusts those expenses to reflect known and measurable changes between the test year and the
18 period the rates will be in effect.⁵² It is recognized that not all costs in the adjusted test year will
19 precisely match the values derived from the use of this ratemaking methodology. Under this
20 ratemaking approach, a utility is allowed to submit evidence to show that certain cost changes are
21 highly probable (and thus known and measurable) which fairly balances the competing interests of

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23 ⁴⁶ *In the Matter of the Application of Sunrise Water Company*, Decision No. 71445 (December 23,
24 2009); *In the Matter of the Application of Farmers Water Company*, Decision No. 71510 (March 17,
25 2010); *In the Matter of the Application of Johnson Utilities*, Decision No. 71854 (August 25, 2010)
26 *In the Matter of the Application of Sahuarita Water Company*, Decision No. 72177 (Feb. 11, 2011).

27 ⁴⁷ Ex. A-1 at 12, Jones Dir.

28 ⁴⁸ Ex. S-5 at 26, Brown Dir.

⁴⁹ Ex. A-12 at 7, Spitzer Rebut.

⁵⁰ Tr. Vol. I at 178-79.

⁵¹ Ex. A-8 at 22, Bourassa Rebut.

⁵² See generally, C.F. Phillips, Jr., *The Regulation of Public Utilities* at 176-77 (3d 1993); Arizona
Administrative Code R-14-2-103.

1 the utility's ratepayers and shareholders. But the Company's argument that all expenses are estimates
2 is a misstatement of traditional ratemaking principles. As with any other rate application, Pima
3 submitted actual expenses that were incurred in the test year before adjustments were made. The
4 evidence in this case shows that Pima, as a company, pays neither state nor federal income taxes.
5 Simply put, payment of taxes simply was not one of Pima's *actual* expenses in the test year.

6 The Company has made much of the fact that Pima's owners as individuals, and like many
7 other investors, will pay income tax on earnings and distributions from the Company. Under federal
8 and state tax law, these sources of income are taxed at the owners' personal income tax rate.⁵³ This is
9 a direct corollary of Pima's internal decision to choose a Subchapter S corporate form and enjoy its
10 attendant benefits. These tax obligations are not, however, expenses that Pima (as an incorporated
11 entity) itself must pay.⁵⁴

12 The Company argues that S-Corps (and other pass-through entities) are harmed by the
13 Commission's practice to disallow an income tax allowance.⁵⁵ Mr. Spitzer testified that utilities are
14 forced into a Hobson's choice in deciding what type of business to select.⁵⁶ However, the Company
15 could not name one utility that sought to organize as a C-Corp to avoid the Commission's policy.⁵⁷

16 The Company relies on the policy of the Federal Energy Regulatory Commission ("FERC")
17 in support of its argument that Pima should be allowed an income tax allowance as a cost of service.⁵⁸
18 However, the FERC has other policy reasons that guided its decision that are not present in Arizona,
19 such as the need to raise capital investment to build needed infrastructure for oil and gas pipelines
20 necessary to transverse the United States to provide service to millions of Americans.

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25 ⁵³ Ex. S-10 at 9, Brown Surrbt.
26 ⁵⁴ *Id.* at 12.
27 ⁵⁵ Ex. A-1 at 14-15, Jones Dir.
28 ⁵⁶ Tr. at 239:9-21.
⁵⁷ Tr. Vol. I at 186-87.
⁵⁸ Ex. A-1 at 14, Jones Dir.

1 **C. Background of the FERC policy.**

2 FERC adopted its *Lakehead* policy regarding income tax allowances in 1996 in an oil-pipeline
3 rate proceeding.⁵⁹ FERC's policy, known as the *Lakehead* policy after the case in which it was first
4 applied, was to allow publically traded partnerships an income tax allowance only to the extent they
5 had corporate partners.⁶⁰ FERC reasoned that corporate income taxes, assessed against an entity's
6 corporate owners, acted as an extra layer of taxation, in addition to the personal income taxes paid by
7 the entity's ultimate individual investors. FERC's *Lakehead* policy was intended to eliminate this
8 "double taxation." The *Lakehead* policy did not provide for any allowance for the individual
9 investors' personal income taxes.

10 In 2004, the U.S. Court of Appeals, D.C. Circuit overruled this policy, in *BP West Coast*
11 *Products, LLC v. FERC* ("BP West Coast"), on the grounds that "the Commission's opinions in
12 *Lakehead* do not evidence reasoned decision making for their inclusion in cost of service corporate
13 tax allowances for corporate unit holders, but denial of individual tax allowances reflecting the
14 liability of individual unit holders."⁶¹ The court also found fault with FERC's *Lakehead* policy
15 because it appeared to be granting income tax allowances to regulated entities that did not actually
16 pay income taxes.⁶² The court, however, left the door open for FERC to revise its *Lakehead* policy
17 by indicating that it could have sustained the Commission's decisions under review if those decisions
18 had evidenced the reasoned decision making the Court found lacking in *Lakehead*.

19 FERC responded to *BP West Coast* in 2005 by issuing its Policy Statement on Income Tax
20 Allowances.⁶³ In that Policy Statement, the Commission concluded that an income tax allowance

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23 ⁵⁹ Opinion No. 397, *Lakehead Pipe Line Co., LP*, 71 FERC ¶61,338 (1995); Opinion No. 397-A,
Denying Rehearing and Clarifying Opinion No. 397, 75 FERC ¶61,181(1996) (referred to together as
24 "*Lakehead*").

25 ⁶⁰ A publicly traded partnership (PTP) is exactly what its name suggests: a limited partnership the
interests in which (known as "units") are traded on public exchanges, just like corporate stock. The
26 PTPs which engage in active businesses, primarily in the energy industry, are commonly known as
master limited partnerships or MLPs. http://www.naptp.org/Navigation/PTP101/PTP101_Main.htm.

27 ⁶¹ *BP West Coast Products, LLC v. F.E.R.C.*, 374 F.3d 1263, 1288 (2004).

28 ⁶² *Id.*

⁶³ *Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139, *reh'g dismissed*, 112 FERC ¶
61,203 (2005) ("Policy Statement").

1 should be permitted on all partnership interests, or similar legal interests, if the owner of that interest
2 has an actual or potential income tax liability on the public utility income earned through the interest.

3 A primary distinction between the Policy Statement and the *Lakehead* policy is that the Policy
4 Statement does not limit a tax allowance to corporate income tax liabilities. FERC permits an income
5 tax allowance for all entities *or individuals* owning public utility assets, provided that an entity or
6 individual has an actual or potential income tax liability. FERC changed its approach in the Policy
7 Statement to permit an allowance for income tax on “first-tier” income. First-tier income includes
8 the earnings of a pass-through entity that are passed through to a higher level of ownership for tax
9 purposes (as compared to second-tier income, which includes distributions that may be paid to a
10 corporation’s shareholders in the form of dividends).

11 FERC later issued an order in a ratemaking case that implemented the policy.⁶⁴ The order
12 was appealed. In *Exxon Mobil Corporation v. FERC*, the Court showing great deference to the FERC
13 ratemaking authority upheld the FERC Policy Statement.⁶⁵ The Court indicated that while it did not
14 necessarily agree with the policy that FERC had chosen, the policy was not arbitrary and
15 capricious. Distinguishing this action from FERC’s *Lakehead* decision, the Court stated that FERC
16 had provided a reasonable explanation of its reasoning and of how the policy fulfilled its mandate.
17 Under the applicable standard of review, therefore, the Court felt it had no basis for overturning
18 FERC’s decision.⁶⁶

19 As Mr. Spitzer acknowledged, a number of natural gas and crude oil or petroleum products
20 pipeline companies have been organized as, or have been reorganized to become, pass-through
21 entities.⁶⁷ These entities have become a significant source of capital for infrastructure investment. A
22 principal motivation for utilizing such entities was to eliminate one level of entity federal income tax.

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27 ⁶⁴ *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005).

28 ⁶⁵ 487 F.3d 945 (2007).

⁶⁶ *Id.* at 951.

⁶⁷ Tr. Vol. II at 244-246; 245-24-25-246:1-2.

1 For utility commissions that have considered the issue of income tax allowance for pass-
2 through entities, there is a split in the jurisdictions, some allow an income tax allowance; others do
3 not.⁶⁸

4 For example, Indiana does not allow recovery of an income tax allowance for an S-Corp. In
5 *South Haven Waterworks, a Div. of Reliable Development Corp. v. Office of Utility Consumer*
6 *Counselor*, the court upheld the decision of the Indiana Utility Regulatory Commission (“IURC”) to
7 disallow an income tax allowance.⁶⁹ In that case, South Haven Waterworks advanced the argument
8 that although it is organized as a Subchapter S corporation for federal income tax purposes and does
9 not pay or incur income taxes as a taxable entity, the IURC should have recognized that the utility's
10 income flows through to the shareholders and allowed South Haven to recover the amount of
11 individual income tax attributable to the shareholders. The court noted that the IURC found that
12 there was no evidence that the shareholders actually paid income taxes attributable to income from
13 the utility during the test year or at any other time.⁷⁰ To impute such a hypothetical tax rate would
14 have been speculative and unsupported by the record. South Haven also argued that its S corporation
15 status should be viewed similarly to a subsidiary of a C corporation. The C corporation, as the
16 parent, pays the tax liability incurred by its subsidiary. However, as noted by the IURC, in the
17 parent/subsidiary situation, the subsidiary incurs a stand-alone tax which is paid by the parent. Then
18 shareholders are taxed on any dividends distributed.⁷¹ Under its current status, South Haven is not a
19 taxable entity. The court found that the IURC properly determined that South Haven was not entitled
20 to an adjustment to operating expenses for a hypothetical tax.

21 Contrast this decision with *Suburban Utility Corp. v. Public Utility Com'n of Texas*.⁷²
22 Suburban operated as an S-Corp, therefore, no taxes were paid by the corporation. All profits
23 realized by the utility were paid to the two shareholders as if the corporation was a partnership and
24 the shareholders paid taxes on it as ordinary income. Suburban submitted the sum of \$9,831.12 as
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26 ⁶⁸ See Dec. No. 71445, fn 50-51, W-02069A-08-0406 (Dec. 23, 2009).

27 ⁶⁹ 621 N.E.2d 653 (1993).

28 ⁷⁰ *Id.* at 654.

⁷¹ *Id.*

⁷² 652 S.W.2d 358 (1983).

1 the amount of federal income taxes it would have to pay had it been a conventional corporation. The
2 Public Utility Commission, however, refused to allow the federal income tax expense on the basis
3 that hypothetical taxes should not be allowed a corporation having no legal tax liability.⁷³ The court
4 reversed, stating that “income taxes required to be paid by shareholders of a Subchapter S corporation
5 on a utility’s income are inescapable business outlays and are directly comparable with similar
6 corporate taxes which would have been imposed if the utility operations had been carried on by a
7 corporation.”⁷⁴ The court allowed Suburban a reasonable allowance for federal income taxes actually
8 paid by its shareholders on Suburban’s taxable income or for taxes it would be required to pay as a
9 conventional corporation, whichever is less.⁷⁵

10 Pima has selected an overall tax rate of 27.49 percent with no submittal of documentation to
11 support this rate, other than an assertion in testimony.⁷⁶ While Mr. Spitzer had no recommendation
12 what an overall tax rate should be or how it should be calculated, the Company proposes to use a
13 modified method as used by FERC.⁷⁷ Mr. Bourassa testifies that the Company arrived at the tax rate
14 by drilling down to the ownership level until a taxable or nontaxable entity is reached, then
15 establishing a marginal tax rate for each taxable entity and finally calculating a weighted average tax
16 rate for the combined ownership and applying that tax rate for calculating income tax allowance.⁷⁸
17 As Staff witness Darron Carlson pointed out, if the Commission is to entertain the idea of an income
18 tax allowance, there should at least be a review of the tax returns of the entities and individuals who
19 are shareholders.⁷⁹

20 As was mentioned during the hearing, the issue of an income tax allowance policy was being
21 explored.⁸⁰ Mr. Spitzer even acknowledged that a workshop could flesh out more issues than in the

22 ⁷³ *Id.* at 363.

23 ⁷⁴ *Id.* at 363.

24 ⁷⁵ *Id.*

25 ⁷⁶ Ex. A-6 at 17, Bourassa Dir. Mr. Bourassa testified that he computed the actual effective tax rates
26 for individuals and entities based upon their proportionate share of income at proposed revenues
using the applicable federal and state tax rates. The computed individual effective tax rates (federal
and state) range from a low of about 12.8 percent to a high of about 32 percent.

27 ⁷⁷ Tr. Vol. II at 246:20-23.

28 ⁷⁸ Ex. A-6 at 17 Bourassa Dir..

⁷⁹ Tr. Vol. II at 326:4-22.

⁸⁰ See Docket No. W-00000C-06-0149.

1 middle of a rate proceeding and perhaps the better course of action would be for the Commission to
2 develop a policy statement on the issue of income tax allowance.⁸¹ Workshops had been held in the
3 generic proceeding to examine the merits of imputed income tax expenses to S-Corps and LLCs. The
4 Staff Report was docketed on June 27, 2012. In the Staff Report, Staff acknowledges that the process
5 for determining the appropriateness of imputing income tax expense as a component of the revenue
6 requirement for entities that have no direct income tax obligation such as S-Corps and LLCs is a
7 policy issue for the Commission. Staff recommended that the Commission continue its current
8 practice of not recognizing income taxes as a component of the cost of service when utility services
9 are rendered by an entity classified as an S-Corp.

10 The Commission is not bound by the FERC but by the Arizona constitution and its statutes.
11 No party disputes that it is within the Commission's discretion to allow an income tax allowance.
12 The Arizona Court of Appeals, in the *Consolidated Water Utilities v. Ariz. Corp. Comm'n* case made
13 it clear that it is within the discretion of the Commission allow or disallow income tax expense.⁸²
14 There, the Court held that ". . . the decision to allow or disallow . . . tax expense is to be made by the
15 Commission, and not the Courts."⁸³ Because Pima is a pass through entity and does not pay income
16 taxes, it is not appropriate to include income tax expense in the adjusted test year as a known and
17 measurable expense; as long as it remains a Subchapter S corporation, Pima will not pay any income
18 taxes now or in the future. Accordingly, Pima's request for an income tax allowance should be
19 denied.

20 **IV. COST OF CAPITAL.**

21 The Company's recommended a capital structure consists of 35.4 percent debt and 64.6
22 percent equity.⁸⁴ Staff is in agreement with the Company's proposed capital structure.⁸⁵ Staff and
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26 ⁸¹ Tr. Vol. II at 203:1-3; 217:18-25-218:1-15.

27 ⁸² 178 Ariz. 478, 875 P.2d 137 (1993).

28 ⁸³ *Id.* at 484, 875 P.2d. 143.

⁸⁴ Ex. A-11 at 2, Bourassa Rejoin.

⁸⁵ Ex. S-9 at 2, Cassidy Surrebt.

1 the Company also agree on the cost of debt, 4.25 percent.⁸⁶ The Company is recommending a 10.50
2 percent cost of equity which results in a weighted average cost of capital of 8.29 percent.⁸⁷

3 Staff recommends that the Commission adopt a 9.4 percent return on equity (“ROE”) for the
4 Company.⁸⁸ Staff’s estimated ROE for the Company is based on the average of its discounted cash
5 flow method (“DCF”) and capital asset pricing model (“CAPM”) cost of equity methodology
6 estimates for the sample companies ranging from 9.0 percent for the DCF to 9.7 percent for CAPM.⁸⁹
7 Staff recommends that the Commission adopt a 7.6 percent overall rate of return.⁹⁰

8 Staff utilized two versions of the DCF Model: the constant growth DCF and the multi-stage or
9 non-constant growth DCF in determining the DCF estimated cost of equity.⁹¹ Staff used the financial
10 information for the relevant six sample companies in the DCF model and averaged the results to
11 determine an estimated cost of equity for the sample companies.⁹² As Mr. Cassidy explained, the
12 constant growth model assumes that an entity will grow indefinitely at the same rate, whereas the
13 multi-stage non-constant growth DCF assumes the dividend growth rate will change at some point in
14 the future.⁹³

15 The Company used both the DCF and the CAPM to calculate its cost of equity.⁹⁴ The
16 Company employs two constant growth analyses, Past and Future growth DCF and Future Growth
17 DCF and two CAPM analyses, historical market risk premium and current market risk premium and a
18 build –up risk premium model designed to serve as a check to the DCF and CAPM results.⁹⁵ The
19 Company’s DCF results range from 9.7 percent to 11.3 percent, the CAPM results range from 8.2
20 percent to 13.7 percent. The Company’s recommended ROE includes a 30 basis point downward
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23 ⁸⁶ Ex. A-11 at 2, Bourassa Rejoin.; Ex. S-9 at 2, Cassidy Surrebt.

24 ⁸⁷ Ex. A-11 at 2.

25 ⁸⁸ Ex. S-10 at 2, Brown Surrbt.

26 ⁸⁹ *Id.*

27 ⁹⁰ *Id.* at 3.

28 ⁹¹ Ex. S-8 at 16., Cassidy Dir.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ Ex. A-7 at 2, Brown Dir.

⁹⁵ Ex. A-9 at Sch. D-4.8; D-4.12, Bourassa Rebtt.

1 financial risk adjustment offset by an 80 basis point small company risk premium to compensate the
2 Company for its small size.⁹⁶

3 Staff's DCF cost of equity gives equal weight to historical and analysts forecasts. The
4 Company relies solely on analyst forecast to estimate dividend per share ("DPS") growth in its Future
5 Growth DCF analysis. Staff recommends against such reliance on analysts' forecasts, as analysts'
6 forecasts can be overly optimistic.⁹⁷ As Mr. Cassidy explains, the appropriate growth rate to use in
7 the DCF model is the dividend growth rate expected by investors, not by analysts.⁹⁸

8 Staff also recommends that any financial risk adjustment or small size premium be rejected.
9 With respect to the small company risk premium, the Commission has determined that firm size does
10 not warrant recognition for a risk premium.⁹⁹ As Mr. Cassidy explains, all companies have firm-
11 specific risk; therefore the existence of unique risks for a company does not lead to the conclusions
12 that its total risk is greater than other entities.¹⁰⁰ Firm specific risk can be eliminated through
13 diversification.¹⁰¹

14 In analyzing the appropriateness of a downward financial risk adjustment, Staff normally
15 applies two criteria. The first is whether the utility has a reasonably economic capital structure. Staff
16 considers a capital structure composed of no more than 60 percent equity to meet this condition.¹⁰²
17 Secondly, Staff considers whether a utility has access to equity capital markets.¹⁰³ Notwithstanding
18 the fact that Pima has an equity rich capital structure, Staff is not recommending a downward
19 financial risk adjustment to Pima's cost of equity since it does not have access to the equity capital
20 markets.

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24 ⁹⁶ Ex. S-4 at 4, Cassidy Surrebt.

25 ⁹⁷ Ex. S-8 at 36, Cassidy Dir.

26 ⁹⁸ *Id.* at 37.

27 ⁹⁹ See Dec. No. 64282, W-01445A-00-0962 (Dec. 28, 2001); Dec. No. 64727, G-03703A-01-0263
(April 17, 2002).

28 ¹⁰⁰ Ex. S-8 at 44, Cassidy Dir.

¹⁰¹ *Id.*

¹⁰² *Id.* at 34.

¹⁰³ Ex. S-8 at 34, Cassidy Dir.

1 The Company's recommended cost of equity of 10.5 percent is beyond the range of returns
2 ordered by the Commission in the most recent rate orders for water utilities.¹⁰⁴ Staff's cost of equity
3 recommendation of 9.4 percent is consistent with recent Commission decisions and will result in the
4 setting of just and reasonable rates.

5 **V. BEST MANAGEMENT PRACTICES.**

6 The Modified Non-Per Capita Conservation Program ("Modified NPCCP") is a regulatory
7 program administered by the Arizona Department of Water Resources ("ADWR") that was added to
8 the Third Management Plan for Arizona's Active Management Areas ("AMAs"). It is a
9 performance-based program that requires participating providers to implement water conservation
10 measures that result in water use efficiency in their services areas.¹⁰⁵ Providers must implement a
11 Public Education Program and one or more additional Best Management Practices ("BMPs") based
12 on their total number of residential and non-residential water service connections.¹⁰⁶ Because the
13 Company is in an AMA, it is subject to the requirements.

14 Staff recommended that the Company file at least seven BMPs in the form of tariffs that
15 substantially conform to the templates created by Staff and available on the Commission's website.¹⁰⁷
16 Staff recommended that the Company be allowed to submit the approved six ADWR BMPs and
17 public education program as part of the seven.¹⁰⁸

18 Company witness Ray Jones testified that Pima currently has a public education program and
19 five ADWR approved BMPs in place.¹⁰⁹ The Company objects to the Staff recommendation as being
20 duplicative and excessive.¹¹⁰ When asked if the Company would file tariffs for the ADWR approved
21 BMPS currently approved, Mr. Jones responded no.¹¹¹ The Company acknowledged that it was the
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23 ¹⁰⁴See Docket No. G-04204A-11-0158, *In the Matter of the Application of UNS Gas, Inc.*, Decision
24 No. 73142 (9.75 percent cost of equity); Docket No. W-01303A-09-0343, *In the Matter of the*
25 *Application of Arizona-American Water Company*, Decision No. 72047, (9.5 percent cost of equity).

¹⁰⁵ See <http://www.azwater.gov/azdwr/WaterManagement/AMAs/documents/MNPCCPFAQs.pdf>.

¹⁰⁶ *Id.*

¹⁰⁷ Ex. S-6 at 5-6.

¹⁰⁸ *Id.*

¹⁰⁹ Ex. A-1 at 5.

¹¹⁰ Ex. A-2 at 10.

¹¹¹ Tr. Vol. I at 28:13-25.

1 current Commission practice to require BMPs but that for some smaller water utilities it was not
2 required or the Staff recommendation to require BMPs had been rejected.¹¹²

3 The Commission has required BMPs in the form of tariffs for small to large water utilities.
4 For example, the Commission required Litchfield Park Service Company (“LPSCO”), in Decision
5 No. 72026, submit for Commission consideration within 120 days of the effective date of this
6 Decision, at least five additional Best Management Practices (as outlined in ADWR's Modified Non-
7 Per Capita Conservation Program) above the Company's existing ADWR requirements. LPSCO is a
8 Class A utility; it has approximately 14,000 water customers. The Commission approved LPSCO’s
9 BMPs in Decision No. 72466.

10 In approving a certificate of convenience and necessity application for Ridgeline Water
11 Company, the Commission required Ridgeline to submit at least five BMPs.¹¹³ However, because
12 Ridgeline will not be a large provider, it is not regulated under the Modified NPCCP program and is
13 not required by ADWR to implement BMP(s). Ridgeline nevertheless submitted tariffs for the
14 Commission’s approval. The Commission approved Ridgeline’s tariffs in Decision No.71912.

15 *In the Matter of the Application of Doney Park Water*, Doney Park a non-profit, Class B water
16 utility providing service to approximately 3,400 connected meters in an area northeast of Flagstaff, in
17 Coconino County, Arizona was ordered to submit seven BMP tariffs. In that case, Staff
18 recommended that the Company submit seven BMPs. Doney Park objected to the Staff
19 recommendation but nevertheless submitted the applicable proposed tariffs for Commission
20 consideration.¹¹⁴

21 There are utilities that have not begun service to any customer along with utilities with far
22 fewer connections than Pima who have been required to submit tariffs implementing BMPs. Pima has
23 offered no compelling reason why it should not be required to submit BMPs.

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27 ¹¹² *Id.*

28 ¹¹³ See Dec. No. 70748, W-20589A-08-0173 (Feb. 12, 2009).

¹¹⁴ Dec. No. 72746, W-01416A-10-0450 (Jan. 20, 2012).

1 **VI. RATE DESIGN.**

2 Under Staff's rate design, Staff recommends a monthly minimum charge of \$7.00 for a 5/8 x
3 3/4 inch meter, for the water division.¹¹⁵ Staff's rate design for the water division did not change from
4 its Surrebuttal position.¹¹⁶ Under Staff's typical bill analysis, the average customer, using 6,395
5 gallons would experience a 14.36 percent increase.

6 For the sewer division, Staff recommends a monthly charge of \$23.91 for a 5/8 x 3/4 inch
7 meter. In its final schedules, for the wastewater division, Staff reduced the monthly minimum charge
8 for effluent customers by \$50 from \$230 in its Surrebuttal recommendation to \$180 in its final
9 schedules.¹¹⁷

10 Under Staff's typical bill analysis, the average wastewater customer on a 5/8 x 3/4 inch meter
11 would experience a 5.2 percent increase, contrasted with the Company's rates, the typical customer
12 would experience a 22.3 percent increase.¹¹⁸ Staff's recommended rate designs are reasonable and
13 should be adopted.

14 **VII. CONCLUSION.**

15 For the foregoing reasons, Staff respectfully requests the Commission to adopt its
16 recommendations in this proceeding.

17 RESPECTFULLY SUBMITTED this 3rd day of July, 2012.

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115 Ex. S-10 at ex. CSB-19 at 1.

27 116 Staff Final Sch. CSB-19 (June 26, 2012).

28 117 Staff Final Sch. CSB-20 (June 26, 2012).

118 *Id.* at CSB 21.



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